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Transcript Exhibit(s)

Docket #(s): WS-D1303A-02-0867

WS-D1303A-02-0868

WS-D1303A-02-0869

WS-D1303A-02-0870

W-D1303A-02-0908

Exhibit #: AFJGI, AUIAI



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HEARING

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ARIZONA CORPORATION COMMISSION
HEARING DIVISION

Frank J. Grimmelmann
42441 N. Cross Timbers Court
Anthem, AZ 85086
Anthem Resident
Chairman, Anthem Country Club Homeowners Association, Inc. Finance Committee

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

MARC SPITZER - CHAIRMAN
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
MIKE GLEASON
KRISTIN K. MAYES

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OCT 31 2003

ARIZONA CORPORATION COMMISSION
HEARING DIVISION

IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY,
INC., AN ARIZONA CORPORATION, FOR A
DETERMINATION OF THE CURRENT FAIR
VALUE OF ITS UTILITY PLANT AND
PROPERTY AND FOR INCREASES IN ITS
RATES AND CHARGES BASED THEREON
FOR UTILITY SERVICE BY ITS SUN CITY
WEST WATER AND WASTEWATER
DISTRICTS.

Docket No. WS-01303A-02-0867

IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY,
INC., AN ARIZONA CORPORATION, FOR A
DETERMINATION OF THE CURRENT FAIR
VALUE OF ITS UTILITY PLANT AND
PROPERTY AND FOR INCREASES IN ITS
RATES AND CHARGES BASED THEREON
FOR UTILITY SERVICE BY ITS SUN CITY
WATER AND WASTEWATER DISTRICTS.

Docket No. WS-01303A-02-0868

IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY,
INC., AN ARIZONA CORPORATION, FOR A
DETERMINATION OF THE CURRENT FAIR
VALUE OF ITS UTILITY PLANT AND
PROPERTY AND FOR INCREASES IN ITS
RATES AND CHARGES BASED THEREON
FOR UTILITY SERVICE BY ITS MOHAVE
WATER DISTRICT AND ITS HAVASU WATER
DISTRICT.

Docket No. WS-01303A-02-0869

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3 IN THE MATTER OF THE APPLICATION OF
4 ARIZONA-AMERICAN WATER COMPANY,
5 INC., AN ARIZONA CORPORATION, FOR A
6 DETERMINATION OF THE CURRENT FAIR
7 VALUE OF ITS UTILITY PLANT AND
8 PROPERTY AND FOR INCREASES IN ITS
9 RATES AND CHARGES BASED THEREON
10 FOR UTILITY SERVICE BY ITS AGUA FRIA
11 WATER DISTRICT AND ITS ANTHEM / AGUA
12 FRIA WASTEWATER DISTRICT.

Docket No. WS-01303A-02-0870

8 IN THE MATTER OF THE APPLICATION OF
9 ARIZONA-AMERICAN WATER COMPANY,
10 INC., AN ARIZONA CORPORATION, FOR A
11 DETERMINATION OF THE CURRENT FAIR
12 VALUE OF ITS UTILITY PLANT AND
PROPERTY AND FOR INCREASES IN ITS
RATES AND CHARGES BASED THEREON
FOR UTILITY SERVICE BY ITS TUBAC
WATER DISTRICT.

Docket No. WS-01303A-02-0908

13
14 **NOTICE OF FILING
SURREBUTTAL TESTIMONY of**

15 **Frank J. Grimmelmann**

16 **Anthem Resident &**

17 **Chairman Finance Committee, Anthem Country Club Homeowners Association, Inc.**
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1 Q. Please state your name and present position for the record.

2 A. My name is Frank J. Grimmelmann. My business address is 42441 N. Cross Timbers
3 Court, Anthem, AZ 85086. My telephone number is (623) 551-1526. I am a resident
4 of Anthem, Arizona, Chair the Finance Committee for the Anthem Country Club
5 Homeowners Association, Inc., and through the Finance Committee serve as a unpaid
6 advisor to the Community Council Liaison Committee which represents the entire
7 community on matters regarding Arizona American Water Company's ("AZAWC")
8 proposed rate increase.

8 Q. Please state your present occupation for the record.

9 A. I am the Founder & Board Member of UltraBridge, Inc., a company that provides full
10 information technology and back room business process outsourcing for post acute
11 care health organization chains that range from Skilled Nursing Facilities to Home
12 Health Agencies and Community Based Organizations. With a business model that
13 focuses on driving quality of care, profitability and top line growth, we presently serve
14 customers in over 30 states, having began operations 5 years ago this coming
15 February. Officially, I'm an employee of F.J. Grimmelmann & Associates, Inc.
16 ("FJG&A"), a company founded 22 years ago that offers capital, consulting and
17 operations management support for companies that range from start ups to those
18 more established companies positioned to and wishing to maximize their market
19 position and investor value. FJG&A serves as an advisor to UltraBridge. All of these
20 companies operate under the umbrella of TGG Holdings, essentially my personal
21 investment and management organization.

21 Q. Please state your educational qualifications and relevant experience for testifying with
22 regard to the AZAWC application for an increase in rates.

23 A. Educationally, I hold a Masters Degree in Business Administration from the University
24 of California at Berkeley in International Business and Finance, and a Bachelor of Arts

1 Degree in Operations Management with a concentration in Business Law from the
2 University of South Florida in Tampa. Historically, I have senior management and
3 consulting experience in operational financial management, technology and the capital
4 markets, having served as the Chief Executive Officer, Chief Financial Officer, and
5 Chief Information Officer of health care organizations ranging from start ups to
6 established health care systems with annual revenues of \$1.3 Billion. I have also
7 served as the national manager and senior vice president for health care investment
8 banking for Shearson American Express and Paine Webber, Jackson & Curtis. I have
9 contributed to two books on short term investment strategies and returns, and have
10 developed numerous capital market financial solutions in strategic partnerships with
11 both Citibank and Goldman Sachs. I have also served as an expert witness on the
12 capital markets with regard to health care regulatory agencies. Finally, I have served
13 as the CEO of start up and emerging organizations, positioning them to maximize there
position in the markets.

14 Q. On whose behalf are you testifying in this proceeding.

15 A. On behalf of myself, as a resident who is affected by the outcome in this proceeding,
16 and the interests of the Anthem Community as the Chairman of the Anthem Country
17 Club Homeowners Association Finance Committee, in my capacity as an Intervenor in
18 this proceeding.

19 Q. What is the purpose of your rebuttal testimony in this proceeding?

20 A. My testimony is being filed in response to and support of the direct testimony of Staff
21 and RUCO, and also in response to the direct and rebuttal testimony of AZAWC and
22 the rebuttal testimony of others in support of AZAWC. I will generally be covering
23 issues related to: 1) The rate increase proposed by AZAWC for the Anthem Water
24 and the Anthem Waste Water rates and Staff/RUCO's recommendations with regard
to these rates, 2) A high level review of the appropriateness of Staff and RUCO

1 proposed adjustments related to AZAWC's proposed rate increase, and 3) Factors to
2 be considered in setting the appropriate AZAWC equity rate of return.

3 Q. What are your observations with regard to the rate increase proposed by AZAWC for
4 the Anthem Water and the Anthem Waste Water rates and Staff/RUCO's
5 recommendations with regard to these rates?

6 A. As a community Anthem presently pays a high rate relative to other water systems for
7 services due to the unique nature and high quality of our 'state of the art' water
8 infrastructure. We can summarize our communities feelings about this with the
9 following points: 1) Under the present Commission rate setting methodology, there
10 are legitimate differences in the cost of water at Anthem and other communities since
11 ground water is not used due to all water being pumped from CAP though a state of
12 the art water treatment system, and the higher costs associated with meeting current
13 code and more recent construction. 2) The proposed 32.45% increase for combined
14 Anthem Water and Waste Water (during a period of 11.9% inflation) over an existing
15 base water rate that is already the highest rate in the area, and roughly 123% higher
16 than the average of the other AZ AZWAC water & sewer rates (excluding Anthem),
17 appears inequitable and inappropriate just from a standpoint of reason. 3) RUCO,
18 which is charged with advocating for consumers in the case of any proposed water
19 utility rate increase, and Staff are the appropriate bodies to review the highly complex
20 application for a rate increase, 4) Both Staff and RUCO appear to have given
21 particular and appropriate focus to the proposed Anthem increases, having
22 undertaken a thorough audit to review among other issues the capacity, capital and
23 cost allocations that were used to establish the initial base rates, and appropriate
24 present rates under the State's rate setting methodology. 5) Today's rates, the
proposed AZAWC rate increase, and the proposed reductions of Staff and RUCO on the

average customer's monthly bill are summarized in the following table:

Average Residential Customer's Monthly Bill Under Various Approved Rates

	<u>Today</u>	<u>AZAWC</u>		<u>ACC STAFF</u>		<u>RUCO</u>	
Water	\$ 31.32	\$36.62	16.9%	\$19.92	-36.4%	\$24.49	-21.8%
Sewer	<u>\$ 30.00</u>	<u>\$45.45</u>	<u>51.5%</u>	<u>\$ 27.53</u>	<u>-8.23%</u>	<u>\$35.86</u>	<u>19.53%</u>
	<u>\$ 61.32</u>	<u>\$82.07</u>	<u>33.8%</u>	<u>\$47.45</u>	<u>(13.9%)</u>	<u>\$60.35</u>	<u>(1.6%)</u>

Above chart represents the Average Customer's Monthly Charges for a 3/4" meter (most common meter size for residential customers in Anthem). Actual Customer's bill may vary according to the amount of water consumed and you can get an estimate of your actual bill by multiplying the percentage increase for the water and sewer rate times those components on your actual bill.

7) If the AZAWC rate increase is granted, it rewards the inaccurate (or potentially incompetent) initial rate estimates requested by the former Citizens Water Company, and the acceptance of these rates by AZAWC at the time of acquisition from Citizen's Water Company based on Staff and RUCO's application of the rate formulas applicable for AZ Utility rate setting. 8) We conclude that the Commissioners should either accept Staff and RUCO's recommendation to deny the rate increase on the basis of the quality of the submission, or to support Staff and/or RUCO's recommendations for an appropriate rate level based on the application and supporting evidence submitted by AZAWC.

Q. Why do you feel that Staff's and RUCO's recommendations should be supported by the Commission with regard to Staff and RUCO's suggested adjustments?

1 A. Rather than comment on each of the 10 or more adjustments that Staff made to
2 AZAWC's rate application, I will instead focus my comments on three general areas
3 that seem to account for and summarize the major adjustments at a high level that
4 result in the recommendations for average decrease in the overall bill of the Anthem
5 residents: 1) AZAWC duplicated its recovery for inflation by requesting the application
6 of RCND valuation of the assets and depreciation against this base, versus historical
7 cost of the assets, while simultaneously requesting a return on equity that implicitly
8 provides for inflation under the AZ rate setting methodology, 2) AZAWC proposed to
9 recover its acquisition premium paid for the Citizen's Water Company at the time of
10 acquisition, and 3) AZAWC used estimated costs in its application when lower actual
11 cost were available & inconsistently mixed its own cost basis and Citizen's cost basis to
12 support its position based on the detailed audit of Staff and RUCO. While the
13 remaining adjustments also impact the rate, these are the specific items that I will focus
14 on.

15 Q. Please expand on your comment with regard to the proper methodology for permitting
16 the recapture of inflation being double counted in the application?

17 A. Let me provide an example. Assume that you have a brand new water system's fixed
18 assets valued at \$100 as its total cost of construction and that this amount reflects all of
19 the assets on the Balance Sheet. Essentially, for purposes of comparison, let's
20 assume for simplicity that the inflation rate is 7.9%, and that we wish to replace the
21 asset after 10 years. We assume 7.9% compounded annually for purposes of
22 illustration only since the value of \$1 at the end of 10 years will double, i.e. \$1 of assets
23 is now nominally equal to \$2. Essentially, the replacement cost for the same physical
24 building and equipment in our example which cost \$100 at the time that it was placed in
service, now has a nominal value of \$200 (or costs \$200 to replace) 10 years later
given our assumed annual inflation rate of 7.9%, i.e., the same physical asset costs

1 twice as much. Therefore, assuming presently that the building is totally financed by
2 equity, the utility would need to have an annual rate of return equal to the rate of
3 inflation on its equity to replace the assets at there replacement cost.

4 In Summary, assuming that the acceptable rate of return on equity provides for inflation
5 in its calculation and is in turn applied to the historical value of the AZAWC's assets at
6 the time that Citizen's built them, there is no need to adopt the RCND methodology
7 which also accounts for inflation in restating the value of the assets presently. Doing so
8 inherently results in duplicating the recovery for inflation and amounts to a double dip.

9 Q. Are you suggesting that AZAWC should receive a 7.9% return simply for the recovery
10 of inflation before taking into account other factors?

11 A. Absolutely not. I am suggesting that the recommendation to make an adjustment to the
12 application to deny the application of the RCND methodology be supported by the
13 commission since doing otherwise would double count inflation as RUCO suggests just
14 through mathematical logic. The actual rate of inflation utilizing the CPI, or the GNP
15 Deflator for the 2002 year is somewhere at or below 2%. Alternatively, the Handy
16 Whitman Index, a privately prepared proprietary index applied by some Utility rate
17 setting agencies could be used and should yield comparable results. However, some
18 rate setting bodies, such as the Minnesota Public Utilities Commission, have not
19 accepted the traditionally used Handy Whitman Index since it is a proprietary formula
20 and not generally obtainable or widely published for easy access. Therefore, the return
21 for inflation is 2% or less presently and is implicitly included in the acceptable rate of
22 return on equity which I will discuss separately in my subsequent testimony.

23 Q. Why do you feel that AZAWC should not be allowed to recover the premium paid to
24 Citizen's Water Company in the purchase price that it paid to acquire the company's
assets, and that this proposed adjustment should also be supported by the
Commission?

1 A. Logically, if an inflated price could be passed on to residents in a rate increase every
2 time that a company is acquired, it would perpetuate inefficiencies and encourage
3 unnecessary and inadvisable acquisitions that are not in the public's interest. If the
4 Commission approved the recovery of this premium, possibly I might just buy the
5 assets from AZAWC at twice the purchase price they paid to Citizen's, and simply ask
6 that the rates be increased further so that I can recover this premium. Seriously, this is
7 a basic premise of accounting and economics that is fairly obvious. Clearly, the
8 Commission should support the recommendation for this adjustment, denying the rate
9 increase associated with it.

10 Q. Turning to another point, why do you support Staff and RUCO's contention that there
11 should be an adjustment to reflect a consistent approved basis for calculating costs?

12 A. If actual costs are available and consistent with the approved methodology for Arizona
13 rate setting, why would you mix and use estimated costs. Likewise, is it logical to mix
14 the cost basis of AZAWC and Citizen's in establishing the basis for cost in the rate
15 setting process when actual numbers are now available consistent with the AZ rate
16 setting methodology, and the correct basis with these numbers available should be the
17 costs of AZAWC to deliver water. In short, applying this adjustment is logical and
18 straightforward, and should be supported by the Commission.

19 Q. What is your position with regard to the difference that exists between Staff's and
20 RUCO's recommendations on the appropriate return on equity for AZAWC once the
21 cost basis is agreed upon under the AZ rate setting methodology?

22 A. Rather than comment on a specific rate of return on equity, since I am testifying as a
23 'real world practitioner' and not an expert witness in Utility rate setting, I prefer to
24 address this from a practical philosophical foundation. This testimony will build upon
my prior comments on inflation, and arrive at some real world observations that the
Commission can consider in its deliberations on the appropriate rate of return on

1 equity.

2 Before proceeding with this analysis, I would like to make the practical observation that
3 the Capital Asset Pricing Model ("CAPM") is the underlying foundation for all modern
4 capital theory, and the practical operation of our capital markets. It would be
5 irresponsible to base the rate of return on a business strategy adopted by any firm,
6 even if that firm happens to be Citibank, a company that I have strategically partnered
7 with in the past. CAPM is a logical and appropriate foundation for the rate setting
8 mechanism in Arizona and fortunately this is recognized by Staff and RUCO.

9 Staff and RUCO each employ methodologies to arrive at an adequate rate of return
10 under rate setting mechanisms in the State of Arizona that are substantially less than
11 that requested by AZAWC and other 'experts' that support their position. It is obvious
12 that the rate of return on equity must provide a return that allows a utility to
13 competitively attract public capital in the markets, and to compete with peers
14 demonstrating good management. However, given the unique monopoly position of a
15 utility, providing an excess margin which would inappropriately position AZAWC to be
16 more profitable than its peers shouldn't inappropriately be permitted at the expense of
17 consumers. Generally, the rate of return of any utility is lower than businesses that are
18 in a more competitive market due to the fact that the utility is in a monopoly position.
19 Specifically, since consumers must pay the rate set by the Commission or risk having
20 their water shut off, the utility is in a unique position to collect monies from the residents
21 they serve as a pass-through to their investors who benefit from either dividends or
22 capital gains on sale. Since utilities enjoy a diversified broad base of consumers who
23 purchase their product, needless to say they benefit from lower volatility and risk than
24 the average company in a competitive market environment. This accounts for their low
'beta factor' or minimal risk against correlation of movements in the general market.

1 Therefore one would expect their risk adjusted rate of return to be lower to attract
2 investors with an appetite for less volatile securities.

3 Q. Given this assessment, what is the appropriate theoretical rate of return?

4 A. This is developed and defined by CAPM in determining both the theoretical and
5 practical rate of return that a company should earn. Again, let's turn to the model that
6 we previously discussed during my earlier comments on inflation, and expand the
7 balance sheet to include current assets, liabilities and equity, in addition to the fixed
8 assets in a simple example.

9 Simplifying assumptions, let's build on our previous example by assuming the following:

10 1) liquid current assets are two times the level of current liabilities (cash and accounts
11 receivable are essentially twice the amount of current trade credit and other liabilities
12 as a measure of liquidity), 2) The long term debt to asset ratio is 66 2/3% (essentially,
13 each \$1 of assets purchased is financed by .667 cents of debt and .333 cents of equity
14 to avoid excessive leverage in the financial structure), and 3) that 20% of the total
15 assets are current assets (cash and other liquid assets) with the remaining assets
16 (building and equipment), 4) that we still have \$100 of total assets, 5) that our
17 simplifying assumption for inflation remains at 7.9% (so that at the end of 10 years our
18 same physical assets will nominally double in value), and 6) that fixed assets will be
19 replaced annually as they depreciate, i.e. the annual depreciation is immediately
20 reinvested into fixed assets so that no funded depreciation reserves are necessary.

21 Given these assumptions, let's see what happens to our balance sheet over a ten year
22 period. First, the physical assets (cash, receivables, building and equipment) will
23 nominally double in value, so that the equivalent assets required to do the job that cost
24 \$100 at the outset will nominally appear as \$200 in our balance sheet at the end of
year 10, i.e. \$1 equals \$2 when compounded annually at 7.9% over a 10 year period.

The relationship of Current and Fixed assets are assumed to remain proportional, so

our initial \$20 in current assets will grow to \$40, and our \$80 in fixed assets will grow to \$160 at the end of ten years, respectively (simply stated the inflation proportionately affects each asset class equally). Therefore, at the end of 10 years, we have \$200 in assets, comprised of \$40 in liquid current assets and \$160 in fixed assets.

Q. So given the doubling of the Assets over the 10 year period, what happens to the liabilities and equity side of the balance sheet required to finance inflation alone, recognizing that the basic accounting definition requires that Assets must equal liabilities + equity at all times?

The answer to this depends on the rate of return being earned on equity after paying the interest on the debt. To make this point, let's first examine what happens when the company earns no net income at all over the period. Essentially, assuming that the company continues to have access to the capital markets and trade credit, at the end of ten years the relationship of current assets to current liabilities (Current ratio is 2 times multiple or \$20/\$10 in time period zero) would remain proportional and the balance sheet would have \$40 in current assets supported by \$20 in current liabilities at the end of the period given our simplifying assumptions. In turn, what happens to the long term debt and equity required to finance the remaining \$160 in assets (\$200 in assets less \$40 financed by current liabilities <essentially trade credit>)? Since equity will remain constant at \$33.33 (1/3 equity), then the remainder of the required financing would have to be provided by long term debt of \$146.67 (\$200 assets - \$20 current liabilities - \$33.33 equity = \$146.67 required long term debt). This holds true because the only thing that will increase the equity, other than the sale of new stock, is net income. Also, since we assumed to be at accounting breakeven, there were also no losses that reduce equity.

1 Q. So what income would be required to achieve 'economic breakeven', which we'll define
2 as the return necessary to maintain a stable relationship between the liability and equity
3 components of the balance sheet?

4 A. The point again is that the rate of return must at the threshold at least equal the rate of
5 inflation to achieve "economic break even", or equilibrium between debt and equity in
6 the financial structure. Stating this differently, an annual rate of return on equity of
7 7.9% in our example would permit the company to double its equity, thereby
8 maintaining the same proportion of long term debt in its financial structure. In short, the
9 long term debt to asset ratio at the outset and at the end of the 10 year period would
10 remain at 66.667%, creating equilibrium for optimal access to the capital markets.

11 Q. How does this apply to the AZAWC rate application given that you have stated that the
12 current rate of inflation in the current economic environment in 2002 is approximately
13 2% or less?

14 A. Applying this example to our present 'real world' situation, the threshold rate of return
15 on equity to cover inflation is at or below 2%. If this was the allowed rate of return on
16 equity in the present economic environment, AZAWC would be earning a sufficient rate
17 of return to replace its physical plant. However, in practice investors demand a higher
18 rate of return to compensate them for business, political and governmental uncertainty,
19 and other risks associated with investment in a water utility company or a specific
20 investment in AZAWC, including a necessary return to support research and
21 development. Given the present low rate of inflation, the total required rate of return
22 on equity will not be as high today as during a historical high inflationary period. As
23 such, AZAWC and other supporters who base the required rate of return on a market
24 environment that is more inflationary in comparative rates that are employed for
analysis artificially distort the required return.

At the same time, Staff in applying CAPM consistently provides the foundation for a

1 realistic and pragmatic rate of return required to satisfy the capital markets during the
2 current low inflationary period as defined by the capital market itself. As such, my
3 conclusion is that Staff's and RUCO's recommended rates of return are more in line
4 with the theoretical and practical maxims required by investors in the present market
5 environment.

6 Q. Do you have any other points to make in support of the recommendations of Staff and
7 RUCO to assist the Commission in its deliberations?

8 A. Yes, Anthem is a diverse and growing community that consists of families ranging from
9 those just starting out to those on a fixed income, with everything in between. We are
10 also a community that recognizes the cost of quality and the need for AZAWC to earn a
11 fair return dictated by the Arizona rate setting methodologies upon which the present
12 system is based. We don't mind paying our fair share, but feel it would be a travesty to
13 permit AZAWC to enjoy a windfall that is unsupportable by acceptable rate setting
14 methodologies employed in Arizona. Further, we are appalled by Staff's and RUCO's
15 independent assessments of the poor quality of AZAWC's submission, which places a
16 greater burden on Staff and RUCO to undertake an analysis, and in turn, a greater
17 burden on the rate payers to pay the cost of this inappropriate and unwarranted effort
18 of Staff resulting directly from the poor quality of the submission. Based on this, we ask
19 the Commission to give serious consideration to the Staff and RUCO recommendations
20 in your consideration of the AZWAC rate request, and based on this to either deny the
21 request or consider the Staff and RUCO recommendations which would result in an
22 overall decrease to our present average monthly bills in Anthem for Water and Waste
23 Water services.

24 Q. Do you have any further closing observations?

A. Yes based on the detailed audit of Staff and RUCO undertaken in the course of their
analysis, I would like to recognize and commend the developer, Del Webb/Pulte for

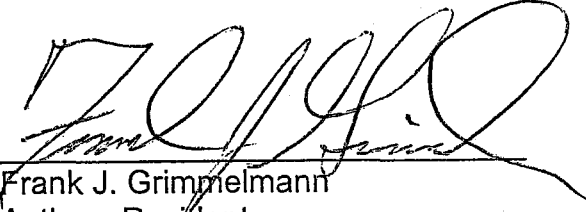
1 being a responsible citizen and meeting its commitment to the residents of Anthem.

2 The analysis appears to support that the developer appropriately transferred the assets
3 required to meet the capacity needs of Anthem to the Citizen's Water Company at a fair
4 market price, and stepped up to meet their obligation to subsidize or underwrite the
5 remaining excess capacity, due to a down sizing of the planned units in Anthem, by
6 contributing equity to the project to absorb what otherwise would have been excess
7 costs born by the Anthem residents. This deserves to be noted for the record.

8 Q. Does this conclude your rebuttal testimony?

9 A. Yes.

10 RESPECTFULLY SUBMITTED this 30th day of October, 2003.

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14 Frank J. Grimmelmann
15 Anthem Resident
16 Chairman, Anthem Country Club
17 Homeowners Association, Inc.
18 Finance Committee
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1 AN ORIGINAL AND TWENTY-ONE COPIES
2 of the foregoing filed this 30th day
3 of October 2003 with:

3 Docket Control
4 Arizona Corporation Commission
5 1200 West Washington
6 Phoenix, Arizona 85007

5 COPIES of the foregoing hand-delivered/
6 mailed this 30th day of October 2003 to:

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EXHIBIT

AU/A-1

BEFORE THE ARIZONA CORPORATION COMMISSION

Marc Spitzer
Chairman
William A. Mundell
Commissioner
Mike Gleason
Commissioner
Jeff Hatch-Miller
Commissioner
Kris Mayes
Commissioner

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AND FOR INCREASES IN ITS RATES AND
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SERVICE BY ITS ANTHEM WATER DISTRICT,
ITS AGUA FRIA WATER DISTRICT AND ITS
ANTHEM/AGUA FRIA WASTE WATER
DISTRICT.

DOCKET NO.
WS-01303A-02-0870

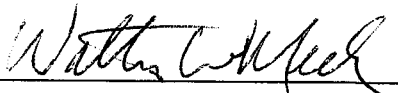
IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY,
INC., AN ARIZONA CORPORATION, FOR A
DETERMINATION OF THE CURRENT FAIR
VALUE OF ITS UTILITY PLANT AND PROPERTY
AND FOR INCREASES IN ITS RATES AND
CHARGES BASED THEREON FOR UTILITY
SERVICE BY ITS ANTHEM WATER DISTRICT,
ITS AGUA FRIA WATER DISTRICT AND ITS
ANTHEM/AGUA FRIA WASTE WATER
DISTRICT.

DOCKET NO.
WS-01303A-02-0871

NOTICE OF FILING TESTIMONY

Pursuant to the revised procedural order in this matter dated June 6, 2003, the ARIZONA UTILITY INVESTORS ASSOCIATION (AUIA) hereby submits the rebuttal testimony of Walter W. Meek.

Respectfully submitted, this 10th day of October, 2003.



Walter W. Meek, President

CERTIFICATE OF SERVICE

An original and 13 copies of the referenced testimony
filed this 10th day of October, 2003, with:

Docket Control
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Copies of the referenced testimony
hand delivered this 10th day of October, 2003, to:

Christopher Kempley, Esq., Legal Division
Teena Wolfe, Esq., Hearing Division
Ernest Johnson, Esq., Utilities Division

A copy of the referenced testimony was
mailed this 10th day of October, 2003, to:

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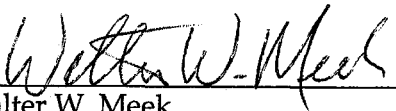
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Walter W. Meek

2 **REBUTTAL TESTIMONY OF WALTER W. MEEK**

3

4 **I. INTRODUCTION, QUALIFICATIONS AND PURPOSE OF TESTIMONY**

5 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

6 A. My name is Walter W. Meek. My business address is 2100 North Central
7 Avenue, Suite 210, Phoenix, Arizona 85004.

8 **Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?**

9 A. I am the president of the Arizona Utility Investors Association ("AUIA"), a
10 non-profit organization formed to represent the interests of equity owners
11 and bondholders who are invested in utility companies that are based in or
12 do business in the State of Arizona.

13 **Q. DOES THE AUIA MEMBERSHIP INCLUDE THE OWNERS AND**
14 **OPERATORS OF ANY OF ARIZONA'S REGULATED WATER**
15 **COMPANIES?**

16 A. Yes. AUIA's members include large Class A water companies and smaller
17 Class B and C water companies. In addition, AUIA is an associate member
18 of the Water Utilities Association of Arizona and three of the members of
19 the AUIA Board of Directors are from the water utility industry.

20 **Q. ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS**
21 **PROCEEDING?**

22 A. On behalf of AUIA, an intervenor in this proceeding. My testimony is
23 being filed concurrently with the company's testimony because AUIA's
24 position is more closely aligned with the company.

25 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

26 A. The purpose of my testimony is to respond to Staff's assertion that firm-
27 specific or so-called "unique" risk should not be considered in determining
28 an equity return because investors in Arizona-American Water Company,

2 or any other Arizona gas, electric, water or sewer utilities, do not consider
3 such firm-specific risks in making investment decisions. I will also discuss
4 the Staff's response to the company's proposal for establishing its Fair
5 Value Rate Base (FVRB).

6 **Q. WOULD YOU PLEASE EXPLAIN WHY YOU ARE QUALIFIED TO**
7 **PROVIDE TESTIMONY ON THIS SUBJECT MATTER?**

8 A. I represent the largest cross-section of utility stockholders in the State of
9 Arizona and I have been involved with the utility business in Arizona for
10 28 years. I have participated in dozens of Commission dockets on behalf of
11 AUIA and testified in numerous proceedings. My testimony has covered
12 topics including rate of return issues, stranded costs, disposition of
13 regulatory assets, AFUDC, inclusion of CWIP in rate base and the impact
14 of regulatory decisions on analyst and investor expectations.

15 **Q. THEN, ARE YOU TESTIFYING AS AN EXPERT WITNESS?**

16 A. I am testifying as a "real world" witness. In this docket, Staff recommends
17 an inadequate 9.7% return on equity based on financial theory found in
18 some economics textbooks. Staff also supports a backward-looking FVRB
19 that does not reflect the current value of the company's property that is
20 devoted to customer service.

21 On the first point, Staff's financial witness, Mr. Joel Reiker, is
22 apparently well schooled in the academic literature dealing with cost of
23 capital, but I think he has an incomplete understanding of how utility
24 investors in the real world think. No matter what Mr. Reiker's textbooks
25 tell him, it is irrational to believe that an investor would ignore a water
26 company's need to meet a draconian new arsenic standard, or threats to the
27 utility's well fields, or the age and condition of its plant, in making a
28 decision to invest in that company.

2 **II. INVESTOR CONSIDERATIONS**

3 **Q. HAVE YOU PERSONALLY PURCHASED AND SOLD COMMON**
4 **STOCK OR OTHER EQUITY INSTRUMENTS?**

5 A. Certainly, both in and outside the utility arena. Currently, I own stock in
6 several utilities that do business in Arizona.

7 **Q. IN YOUR POSITION WITH AUIA, HAVE YOU DISCUSSED**
8 **INVESTING IN COMMON STOCKS OF UTILITIES AND/OR**
9 **OTHER CORPORATIONS?**

10 A. Yes. Investment in stock, particularly stock in utilities, is the foundation of
11 AUIA's existence. In order to advance the interests of AUIA's members, I
12 have developed a good working knowledge of the utility industry and,
13 specifically, investment related matters.

14 **Q. ARE YOU FAMILIAR WITH THE CRITERIA THAT A TYPICAL**
15 **INVESTOR MIGHT CONSIDER WHEN EVALUATING**
16 **WHETHER TO INVEST IN A UTILITY'S STOCK?**

17 A. I believe I am. At the outset, it may be useful to distinguish between
18 institutional and retail investors. Today, between 60 and 80 percent of the
19 outstanding shares of some utilities are held by institutional investors, such
20 as pension plans and investment trusts. Of the remainder, half or more may
21 be held in "street" name by broker-dealers and the rest are shareholders of
22 record on the corporate books.

23 Although all investors should in theory employ similar investment
24 criteria, some have access to more information than others. A careful
25 investor evaluating whether to invest in a utility would examine several
26 factors such as liquidity and cash flows, debt service coverage, capital
27 structure, customer growth, capital requirements, return on equity, PE ratio,
28 projected earnings and dividend growth and regulatory risk in addition to

2 specific business conditions. Some institutional investors are prohibited
3 from investing in a company that doesn't pay a dividend.

4 Retail investors may or may not have professional investment
5 advisors, but should be interested in the same company-specific data and
6 factors, although their analysis is typically less complex. Since many are at
7 or near retirement age, they are in the "fixed-income" syndrome; they want
8 safety along with consistent growth in earnings and dividends. People in
9 this category often do not have the option of diversification and will have a
10 "portfolio" of three or four dividend paying stocks.

11 **III. THE IMPORTANCE OF UNIQUE RISK FACTORS**

12 **Q. HAVE YOU REVIEWED THE DIRECT TESTIMONY OF STAFF**
13 **WITNESS JOEL M. REIKER FILED IN THIS DOCKET?**

14 A. Yes. Mr. Reiker's testimony gives me great concern for the future of
15 investor-owned utilities in Arizona. For example, on page 6 of his direct
16 testimony, Mr. Reiker states that:

17 Risk is defined in modern portfolio theory as the
18 sensitivity of an investment's returns to market
19 returns. The most prevalent measure of risk is "beta."
20 Beta is the measurement of an investment's market
21 risk, and it reflects both the business risk and financial
22 risk of a firm.
23

24 **Q. ARE YOU FAMILIAR WITH THE TERM "BETA"?**

25 A. Yes, I am familiar with the term "beta" as a tool for measuring the market
26 risk of an investment. It generally measures the sensitivity of the market
27 price of a stock to the market as a whole.

28 **Q. IN YOUR EXPERIENCE, DOES A TYPICAL INVESTOR RELY**
29 **SOLELY ON BETA IN EVALUATING THE RISKS ASSOCIATED**
30 **WITH AN INVESTMENT IN A UTILITY'S STOCK?**

31 A. In my experience, a prudent investor will not rely solely on a beta in

2 making investment choices, irrespective of how diversified his portfolio
3 might be. Sole reliance on a beta could lead to imprudent decision-making
4 by investors. However, Mr. Reiker also testifies in his direct testimony at
5 page 7:

6 Unique risk, or microeconomic risk, is risk that can be
7 eliminated by portfolio diversification, i.e., buying
8 securities in portfolios. Unique risk is not measured
9 by beta nor does it factor into the cost of equity
10 because it can be eliminated through simple
11 shareholder diversification. Unique risks are
12 particular to an individual company or investment
13 project. Investors who hold diversified portfolios do
14 not worry about unique risk; therefore, it does not
15 affect the cost of capital. Additionally, investors who
16 choose to be less than fully diversified will not expect
17 to be compensated for unique risk.
18

19 Any investor who completely ignores what Mr. Reiker terms
20 "unique risk" is going to experience severe disappointments, no matter how
21 diversified his portfolio. I could recite a long list of companies engaged in
22 electric distribution, generation, trading, gas transportation, telephone
23 distribution, long distance, wireless communications, software development
24 and semiconductor manufacturing that have fallen flat since 2000. If you
25 were invested in those companies then, you were probably rich. If you are
26 holding their stock today, along with California bonds, your portfolio may
27 be six feet under water.

28 I would submit that much of the investment loss associated with
29 those companies was the result of the market's failure to recognize and act
30 on "unique" risks that were present in their business plans, their
31 management and the regulatory regimes under which they operated.

32 **Q. SO YOU DO NOT AGREE WITH MR. REIKER'S ASSERTIONS**
33 **ABOUT HOW INVESTORS VIEW "UNIQUE RISK"?**

34 **A.** No. I have not met the investors Mr. Reiker testifies about. The investors I

2 deal with would not willingly accept losses due to company-specific risks
3 simply because they own stock in Disney or Pepsi. I can attest that after
4 Three Mile Island, an electric utility that was building a nuclear power
5 plant was besieged by investors who were worried about the unique risk of
6 that investment. Those considering investments in Arizona's regulated
7 utilities also would not simply ignore the return on equity this Commission
8 authorizes. Capital is not unlimited and prudent investors who consider all
9 their options are not likely to ignore real life risks, as Mr. Reiker seems to
10 believe.

11 **Q. DO YOU AGREE WITH MR. REIKER'S VIEW THAT THE RISK**
12 **ASSOCIATED WITH A PARTICULAR FIRM IS "ELIMINATED"**
13 **IF SECURITIES ARE PURCHASED IN PORTFOLIOS?**

14 **A.** Mr. Reiker makes that point in his direct testimony at page 7 and I do not
15 agree. I would, instead, argue that the risk associated with purchasing a
16 particular firm's securities cannot ever be eliminated. Presumably, each
17 stock in an investor's portfolio presents its own specific set of risks, which
18 could, in theory, be averaged to create an overall risk for the portfolio.
19 However, each stock will have its own risk profile and I believe prudent
20 investors consider those risks in deciding whether to buy or hold a
21 particular security.

22 **Q. DO YOU BELIEVE THAT MR. REIKER IS CORRECT IN**
23 **ASSERTING THAT "INVESTORS WHO HOLD DIVERSIFIED**
24 **PORTFOLIOS DO NOT WORRY ABOUT UNIQUE RISK"?**

25 **A.** I think Mr. Reiker lacks experience as an equity investor. I know that
26 Arizona utility companies and AUIA receive many inquiries from analysts
27 and investors about the probable effect of "unique" or specific risks,
28 including the risk posed by regulatory decisions of this Commission. If Mr.

2 Reiker were correct, we would not receive these sorts of inquiries. They
3 would just look up the company's beta and assume that it has the same risks
4 as other companies with the same beta.

5 I certainly do not ignore unique risks associated with a particular
6 firm when I consider the purchase of that firm's stock simply because I
7 hold a "diversified portfolio," whatever that means. After all, I don't have
8 unlimited wealth and I have to do my homework to make sure I maximize
9 my opportunities for returns on my investments. That is one focus of my
10 concern and the reason for my testimony. If this Commission adopts
11 Staff's high-altitude view of finance and economics, and authorizes
12 unreasonably low rates of return, I fear that investment in Arizona's utility
13 industry will suffer a sharp and debilitating decline.

14 **Q. DOES FIRM-SPECIFIC RISK AFFECT THE COST OF CAPITAL?**

15 A. I believe it does, and Citigroup, the country's largest financial company,
16 provides a timely example.

17 **Q. WOULD YOU EXPLAIN?**

18 A. I have attached to my testimony as Attachment A a copy of a pamphlet
19 distributed this month to its customers by Smith Barney/Citigroup. The
20 pamphlet announces a new stock rating system introduced by the company
21 in September 2003. The company asserts that the new system is a
22 departure because it no longer rates stocks on a relative basis, i.e., in
23 comparison with others in the same industry or in the analyst's universe of
24 coverage. Instead, the rating system is absolute and company-specific. In
25 brief, the system works this way:

26 First the analyst calculates an expected 12-month total return
27 comprised of a target price for the stock and the one-year projected
28 dividend yield. Next, the analyst develops and assigns a risk rating based

2 on a four-tier rating system. Finally, an investment rating, i.e., Buy, Hold
3 or Sell, is established using a ratings-risk-return matrix. For example, in
4 order to receive a Buy rating, a Low Risk stock must have an indicated total
5 return of at least 10 percent and a Medium Risk stock must show a total
6 return of 15 percent or more.

7 **Q. HOW ARE THE RISK RATINGS DERIVED?**

8 A. The pamphlet says that the risk rating will include "quantitative and
9 fundamental" risks that are inherent in the underlying company and stock
10 and will include historic price volatility. However, in conversation with a
11 senior investment executive at Smith Barney, I was told that the risk factors
12 will be unique to the company and its business and could include factors
13 such as the quality of management, liquidity and cash flows, capital
14 structure, credit quality, capital requirements and regulatory risks.

15 **Q. IN OTHER WORDS, UNIQUE RISKS WILL AFFECT MARKET**
16 **PRICE AS A RESULT OF THIS SYSTEM?**

17 A. Yes, contrary to Mr. Reiker's assertions, the customers of Smith
18 Barney/Citigroup will be exposed to a system that rates stocks, at least in
19 part, on risk factors that are unique to the company, and that system is
20 designed to influence decisions to buy or sell stocks.

21 **Q. HOW COULD THAT INFLUENCE THE COST OF CAPITAL?**

22 A. In general, if a company can't develop a robust market for its securities and
23 if its stock can't be sold in the market at a reasonable price, it will
24 inevitably face a higher cost of equity and a higher cost of capital. In this
25 example, the investor's view of whether a rated stock is an attractive
26 investment will be influenced by Smith Barney's judgment about a
27 company's future performance. That judgment will be based on an
28 assessment of the company's intrinsic ability to produce earnings, modified

2 by various risk factors.

3 **Q. SO, IS IT YOUR VIEW THAT FIRM-SPECIFIC RISK SHOULD BE**
4 **WEIGHED IN ESTIMATING THE COST OF CAPITAL?**

5 A. Yes. It is my understanding that in setting rates for utility service, the
6 Commission must allow a utility, in addition to recovering its operating
7 expenses, taxes and depreciation, an opportunity to earn a return that is
8 equal to returns that are being earned on investments in other businesses
9 that have corresponding risks. This is known as the comparable earnings
10 standard, and it has been in effect for decades. For example, in the
11 *Bluefield Waterworks* case, decided in 1923, the United States Supreme
12 Court stated: "A public utility is entitled to such rates as will permit it to
13 earn a return . . . equal to that generally being made at the same time and in
14 the same general part of the country on investments and other business
15 undertakings which are attended by corresponding risks and uncertainties . .
16 . ." *Bluefield Waterworks & Improvement Co. v. Public Service*
17 *Commission of West Virginia*, 262 U.S. 679, 692 (1923).

18 In another important decision, *Hope Natural Gas*, the United States
19 Supreme Court re-emphasized the rate of return principles stated in
20 *Bluefield Waterworks*: "The return to the equity owner should be
21 commensurate with returns on investments in other enterprises having
22 corresponding risks." *Federal Power Commission v. Hope Natural Gas*
23 *Co.*, 320 U.S. 591, 603 (1944).

24 In order to apply the comparable earnings standard, it is necessary to
25 evaluate the firm-specific or unique risks associated with an investment in
26 that particular firm. From the standpoint of a typical investor, I believe that
27 Mr. Reiker violates this standard by choosing to ignore firm-specific risks
28 and relying instead on Value Line betas and the utilities' debt exposure as

2 the sole determinants of risk.

3 **Q. IS THERE A CONFLICT BETWEEN THE COMPARABLE**
4 **EARNINGS STANDARD AND THE CITIGROUP RATING**
5 **SYSTEM YOU JUST DESCRIBED?**

6 A. I don't think so. It might appear so because Citigroup is veering away from
7 rating on a relative basis, but the answer is no, in two respects.

8 First, Citigroup isn't in the regulatory business. Its analysts will
9 pass judgment on a company's earnings capability, but unlike this
10 Commission, they are not responsible for authorizing rates of return.
11 Second, there is nothing to prevent an investor from making his or her own
12 comparisons based in part on Citigroup's analysis. For example, if
13 Citigroup analysts rated all of the water companies in Mr. Reiker's sample,
14 it would be relatively easy for a prospective investor to make his or her own
15 risk comparisons.

16 **Q. DO YOU HAVE AN OPINION REGARDING THE STAFF'S COST**
17 **OF EQUITY STUDIES?**

18 A. As I stated earlier, I disagree with Mr. Reiker's emphasis placed on beta
19 and his failure to acknowledge that investors consider other data and risk
20 factors in evaluating which stock to purchase. Also, his Capital Asset
21 Pricing Model (CAPM) relies on the assumption that all investors hold
22 efficient portfolios and all such portfolios move in lockstep with the
23 market. Reiker Direct at page 21. This may have a theoretical basis, but it
24 is not reality.

25 The results produced by Staff's Discounted Cash Flow (DCF) and
26 CAPM studies may pass a theoretical test, but they are suspect from a
27 common sense perspective. See Reiker Direct at page 25, Tables 6 and 7.
28 The CAPM historical data results in a return of only 7.7% on equity and the

2 constant growth DCF model used by Staff produces a return of only 8.5%.

3 This projected return is substantially less than what water and gas
4 companies are currently earning, and well below Value Line's projections
5 for 2004 and the 2006 - 2008 time period. However, these low returns are
6 averaged with higher results from other Staff analyses to produce an
7 average return of only 9.2%.

8 Simple common sense warns that something is wrong with models
9 that produce such low results compared to actual returns in the market. Mr.
10 Reiker does not really explain how this disconnect occurs. He simply
11 accepts the result produced.

12 **Q. DOES THE STAFF ANALYSIS INCLUDE THE INFORMATION**
13 **THAT A TYPICAL INVESTOR WOULD CONSIDER IN**
14 **EVALUATING THE RISKS OF A STOCK INVESTMENT?**

15 **A.** Not really. As I outlined previously, a typical investor would consider a
16 variety of financial and non-financial factors and circumstances in
17 evaluating whether to purchase a firm's stock. One way of illustrating this
18 point is to consider the information published by Value Line on the water
19 utility industry and on certain publicly traded water companies. Mr. Reiker
20 presumably has reviewed this information since he has used the betas from
21 Value Line in preparing his testimony. See Reiker Direct at page 23.

22 Value Line provides a variety of historical and projected financial
23 data for each of the publicly traded water utilities that it follows, as well as
24 a discussion of various firm-specific and industry-wide events. Applying
25 Mr. Reiker's logic, however, all of this information is simply irrelevant and
26 ignored by investors. There would be no reason for Value Line and other
27 investment services to gather and publish this information, nor would there
28 be any market for this information, if investors didn't consider it in making

2 investment decisions.

3 **Q. ARE YOU CHALLENGING STAFF'S ANALYTICAL METHOD?**

4 A. Not the method, only the result. Both Mr. Reiker and the company's cost
5 of capital witness, Dr. Zepp, have prepared various estimates of the cost of
6 equity for consideration in this case. Dr. Zepp's analysis and his finding in
7 his rebuttal testimony that Arizona-American's cost of equity is in a range
8 of 10.5% to 11.7% make more sense to me than the Staff's findings.
9 However, the Commission ultimately must decide which approach deserves
10 the most weight.

11 **Q. HOW DOES STAFF'S RECOMMENDED RETURN ON EQUITY**
12 **COMPARE TO THE RETURNS BEING REPORTED BY THE**
13 **PUBLICLY TRADED WATER UTILITIES USED IN STAFF'S**
14 **SAMPLE?**

15 A. Staff's sample contains six publicly water traded utilities. According to the
16 information reported in C. A. Turner Utility Reports (Sept. 2003), these
17 companies are currently earning a return on equity of, on average, 10.6%.
18 Actually, Staff's cost of equity finding, based on averaging its DCF and
19 CAPM results, was only 9.2% or 140 basis points below the average in the
20 sample. Mr. Reiker added 50 basis points to his recommendation in
21 recognition of Arizona-American's debt exposure.

22 **Q. BOTH ARIZONA-AMERICAN'S COST OF CAPITAL WITNESS**
23 **AND MR. REIKER HAVE EMPLOYED AN ADDITIONAL**
24 **SAMPLE OF NATURAL GAS COMPANIES. WHAT RETURNS ON**
25 **EQUITY ARE THOSE UTILITIES CURRENTLY REPORTING?**

26 A. Arizona-American's expert has used seven natural gas companies that have
27 A bond ratings. According to C. A. Turner, the average return on common
28 equity for that group of eight gas companies is 11.34%. That is 160 basis

points higher than Staff's final recommendation of 9.7% in this case.

Mr. Reiker has added three other gas utilities to the group, NICOR, Inc., Cascade Natural Gas and Southwest Gas. NICOR's current rate of return is 19.4%, exactly double Staff's recommended return on equity for Arizona-American. The other two gas companies have BBB bond ratings and are currently reporting very low returns on equity, according to C. A. Turner. Cascade Natural Gas is reporting a return on common equity of only 7.4% while Southwest Gas, which is the largest natural gas supplier in Arizona, is reporting a return on common equity of only 7.2%. If these three gas utilities are included in the average, the average return on equity is still 11.3%, again well above what Staff is recommending for Arizona-American in this case.

Mr. Reiker does not discuss the current returns on equity being reported by either sample group of publicly traded utilities. Are those returns on equity relevant to investors? I would think they are and, at a minimum, I would have expected Mr. Reiker to explain why the models he is using are producing results substantially below current returns on equity.

IV. THE SIGNIFICANCE OF REGULATORY RISK

Q. AS YOU INDICATED, A SIGNIFICANT PORTION OF SOUTHWEST GAS' OPERATIONS IS IN ARIZONA AND SOUTHWEST GAS IS CURRENTLY REPORTING THE LOWEST RETURN ON EQUITY OF ALL OF THE SAMPLE GAS UTILITIES. DO YOU HAVE ANY COMMENT?

A. I am on record in that docket in opposition to the Commission's decisions regarding rates and commodity charges. However, I should note that Southwest Gas was granted rate increases in Decision No. 64172 (October 30, 2001) and that the return on equity approved for Southwest Gas in that

2 decision was 11.0%, 130 basis points higher than the equity return being
3 recommended by Staff for Arizona-American.

4 **Q. DOES THE NATURE OF REGULATION IMPACT AN**
5 **INVESTOR'S PERCEPTION OF THE RISK ASSOCIATED WITH A**
6 **PARTICULAR UTILITY STOCK?**

7 A. Yes. A public utility commission can have a significant impact on the
8 investment risk associated with a particular utility stock. During the recent
9 APS financing docket, rating agencies, stock analysts and hedge fund
10 managers were constantly seeking insights into the Commission's probable
11 decision. I am convinced that if the Commission had denied APS' request,
12 Pinnacle West Capital Corporation and its affiliates would have been
13 damaged in the financial marketplace.

14 Now, I am not suggesting that the Commission should avoid taking
15 actions simply because it could impact the risk associated with an
16 investment in a utility it regulates. Nevertheless, if the Commission
17 authorizes a rate of return below what is currently being earned by other
18 utilities, it will be more difficult for the utility to raise capital, bond ratings
19 may be reduced, etc.

20 These factors, which some would call "regulatory risk," are not
21 ignored by investors. In fact, the August 2003 Value Line specifically
22 mentions that regulatory decisions and policies in California are adversely
23 impacting water utilities in that state.

24 It is probably no coincidence that Southwest Gas also operates in
25 California, and the two water utilities currently reporting the lowest returns,
26 American States Water (formerly named Southern California Water) and
27 California Water Service, are based in California. California Water Service
28 has had its credit rating downgraded in the past year or two. Southwest Gas

2 is currently rated BBB- by S&P, which is barely investment grade.

3 **Q. DOES THE NEW MAXIMUM CONTAMINANT LEVEL ("MCL")**
4 **FOR ARSENIC, RECENTLY ESTABLISHED BY THE**
5 **ENVIRONMENTAL PROTECTION AGENCY UNDER THE SAFE**
6 **DRINKING WATER ACT, CREATE ADDITIONAL RISK?**

7 A. Yes, this is a good example of a firm-specific risk that an investor is going
8 to consider, notwithstanding the finance theory relied on by Mr. Reiker.

9 **Q. BUT DOESN'T STAFF ARGUE THAT THE NEW MCL FOR**
10 **ARSENIC IS NOT A FIRM-SPECIFIC RISK BECAUSE IT**
11 **IMPACTS THE ENTIRE WATER UTILITY INDUSTRY?**

12 A. Yes, Mr. Reiker discusses this point on page 59 of his direct testimony.
13 Again, he claims that this is simply a unique risk and would not be "priced
14 by the market." Mr. Reiker does not discuss, and there is no indication that
15 he has investigated, whether the six publicly traded water utilities have
16 arsenic in their water supplies and, if so, how much they will be required to
17 spend to comply with the new EPA requirement.

18 According to Mr. Reiker, the "Modern Portfolio Theory" justifies
19 ignoring these sorts of risks in setting rates, even though investors can and
20 do consider them, based on my experience.

21 **Q. SO IS IT YOUR BELIEF THAT REGULATION ITSELF AFFECTS**
22 **INVESTOR RISK?**

23 A. Yes. As I discussed above, there are numerous examples of regulatory
24 decisions (or the lack thereof) impacting stock value, which obviously
25 impacts investor risk. Investors do consider these factors. I know I do and
26 I am an investor.

27 Regulatory lag is yet another example of risk associated with
28 regulation that an investor is likely to consider. It typically takes 13 months

2 or longer (it will be at least 15 months in this docket) to obtain rate relief in
3 this jurisdiction. *Value Line* specifically emphasizes problems being
4 experienced with the California Public Utilities Commission in its most
5 recent discussion of American States Water and California Water Service.
6 Apparently, both of these companies have been waiting for rate decisions
7 from that commission, while their earnings erode. This is another example
8 of a unique factor that influences investors' perception of the risk
9 associated with an investment in a utility.

10 **Q. ACCORDING TO MR. REIKER, SUCH RISKS ARE IGNORED BY**
11 **THE MARKET.**

12 **A.** That's what Mr. Reiker claims, but I do not accept his theory. I can suggest
13 that the most efficient way to minimize or eliminate these types of risks is
14 to reject the investment in the first place, which I fear is the result we are
15 going to see if Staff succeeds in its attempt to drive down equity returns.

16 **V. FAIR VALUE RATE BASE**

17 **Q. IS THERE A CONFLICT BETWEEN STAFF AND ARIZONA-**
18 **AMERICAN ON HOW TO DEVELOP AN APPROPRIATE**
19 **FAIR VALUE RATE BASE?**

20 **A.** Yes. The company proposes that its rate base be determined by
21 reconstruction cost new less depreciation (RCND), while the Staff
22 prefers to use original cost less depreciation (OCLD).

23 **Q. IS THERE A SIGNIFICANT DOLLAR DIFFERENCE?**

24 **A.** Yes. The company's adjusted RCND rate base, based on its rebuttal
25 filing, totals approximately \$137 million while the Staff's OCLD
26 calculation produces a rate base of approximately \$92 million.

27 **Q. WHAT DOES THIS DIFFERENCE MEAN TO AN EQUITY**
28 **INVESTOR?**

2 A. Depending on how the authorized return on equity is applied to the
3 rate base, we would expect that the larger RCND rate base would
4 generate greater dollar returns for the equity investor. However, the
5 underlying issue is which method is more equitable, and which
6 conforms more closely to the requirements of the law. AUUA
7 believes that RCND is superior to OCLD on both grounds.

8 **Q. WHY IS RCND THE SUPERIOR METHOD?**

9 A. Both the law and common sense dictate that a utility company
10 should be allowed to earn a fair return on the actual value of its
11 property devoted to public service. I have already cited the *Bluefield*
12 *Waterworks* case in which the U.S. Supreme Court enunciated the
13 requirement for providing a fair rate of return to equity investors. In
14 that case, the Court also discussed the test to be used in establishing
15 a FVRB, emphasizing that the rates must be "sufficient to yield a
16 reasonable return on the value of the property used at the time it is
17 being used to render the service." The Court overturned the West
18 Virginia commission's decision because it was based on the original
19 cost, and not the property's value at the time rates are set. 262 U.S.
20 at 689 – 692. To that we can add, for example, the judgment of the
21 Arizona Supreme Court in *Simms v. Round Valley Light & Power*, in
22 which the Court declared that the Commission is required to
23 consider the value of a utility's property "at the time of the inquiry,"
24 based on the Arizona Constitution. 80 Ariz. 145, 151, 294 P 2nd 378,
25 382 (1956). In other words, the utility's rate base should reflect its
26 current value at market, not historic or book cost.

27 **Q. DOES RCND MEET THE COURT'S REQUIREMENT?**

28 A. RCND at least approaches actual value, although the recent purchase

2 of Arizona-American's assets, at a price of \$276.5 million, indicates
3 that the company's proposed RCND rate base is well short of market
4 value in 2001 when the sale was consummated.

5 RCND certainly comes much closer to the Court's
6 requirement than does OCLD, which is a backward-looking
7 calculation that is based on historic cost. Book value has no
8 relationship to market value and, therefore, does not reflect the
9 actual value of the utility's property today.

10 When you couple OCLD with the historic test year and a
11 regulatory lag in excess of 12 months, you get the worst of all
12 worlds. Not only is the rate base an historic expression, but the data
13 are two to three years old by the time rates go into effect. This is not
14 an equitable ratemaking system, and in my view, does not comply
15 with the "fair value" requirement in our state's Constitution.

16 **Q. WHAT IS AUIA'S POSITION REGARDING THE**
17 **ACQUISITION ADJUSTMENT?**

18 **A.** With regard to this proceeding, we agree with the company's
19 approach. At the time of the purchase of these systems by Arizona-
20 American, AUIA argued that the issue of recovering the acquisition
21 premium should be postponed until a rate proceeding. The
22 Commission did that in its order approving the sale, but it imposed
23 certain conditions on any future recovery, including a requirement
24 that the company must demonstrate clear benefits that have accrued
25 to ratepayers as a result of the transaction.

26 Company witness Stephenson has proposed that Arizona-
27 American be allowed to defer that demonstration without
28 relinquishing its right to pursue recovery in a future proceeding.

2 Given the transition that Arizona-American has undertaken, from a
3 few thousand customers to roughly 150,000, AUIA believes it is
4 reasonable to postpone consideration of the acquisition adjustment.

5 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

6 **A. Yes.**

Introducing Our New Stock Rating System

October 2003

On September 12, 2003, Smith Barney introduced a new, comprehensive stock rating system that we believe differentiates our research and demonstrates our commitment to providing research of the highest quality. Not only is its new methodology more rigorous and robust, but we are also clearly exposing the underlying components of the rating within the research. This transparency allows you, the investor, to quickly assess the various risks and expected returns that go into the rating and apply these factors to your own investment criteria.

Our new rating system is a significant departure from its predecessor—stocks are no longer rated on a *relative* basis. This means that stocks are not rated relative to others in their industry or to the analyst's universe of coverage. The new rating system is *absolute* in nature. Investment ratings are now determined based on expected total return and risk rating. Ratings in the new system are independent of relative performance to other stocks.

Following is a general explanation of how the new stock rating system works, along with a brief Questions & Answers section that highlights a number of important details. If you'd like additional information, please speak with your Financial Consultant.

How the New Rating System Works

Under the new system, each stock is given a two-part rating, which indicates the following:

Investment Ratings	Risk Ratings
Buy (1)	Low (L)
Hold (2)	Medium (M)
Sell (3)	High (H)
	Speculative (S)

Here's the methodology our analysts use:

Target price and expected total return

Initially, an analyst derives an expected 12-month target price using multiple valuation methodologies (as specified in the Valuation section of the research). The current market price is then compared with the target price to calculate an expected gain or loss. The one-year projected dividend yield, if any, is then added to the expected gain or loss to calculate an expected total return.

Risk rating

The analyst then assesses the risk of a stock based on various quantitative and fundamental factors that relate to the stock's local market/country (as specified in the Risk section of the research). We

are continuing to categorize risk as Low, Medium, High or Speculative. This four-tier risk rating system further differentiates Smith Barney from our competitors who typically have fewer risk levels and more general indicators.

Ratings-Risk-Return Matrix

Finally, based on both the expected total return and risk rating, an investment rating is established using our ratings-risk-return matrix (below). We are categorizing investment ratings as Buy, Hold or Sell.

All published research contains a Valuation and Risk section where analysts must discuss how they derived their price targets and risk ratings. Investors are encouraged to read this section for a detailed description.

Expected Total Returns

Ratings-Risk-Return Matrix

Developed Market: U.S., UK, EU, Australia/New Zealand and Japan

	LOW Risk	MEDIUM Risk	HIGH Risk	SPECULATIVE
BUY (1)	$R \geq 10$	$R \geq 15$	$R \geq 20$	$R \geq 35$
HOLD (2)	$0 < R < 10$	$0 < R < 15$	$0 < R < 20$	$0 < R < 35$
SELL (3)	$R \leq 0$	$R \leq 0$	$R \leq 0$	$R \leq 0$

Emerging Market: Asia Pacific, EMEA and Latin America

	LOW Risk	MEDIUM Risk	HIGH Risk	SPECULATIVE
BUY (1)	$R \geq 15$	$R \geq 20$	$R \geq 30$	$R \geq 40$
HOLD (2)	$5 < R < 15$	$10 < R < 20$	$15 < R < 30$	$20 < R < 40$
SELL (3)	$R \leq 5$	$R \leq 10$	$R \leq 15$	$R \leq 20$

$R = \text{Expected Total Return (12 months)} =$

$[(\text{Target Price} - \text{Current Price}) / \text{Current Price}] + \text{Forecast 12-month Dividend Yield}$

These benchmarks are subject to change.

Sample Research Report Cover

citigroup
Smith Barney

See page 12

BUY (1)

Medium Risk (M)

Market cap: \$1.6 bil.

September 15, 2003

Apparel

Analyst Name
212-816-1111
analyst_name@citigroup.com

ABC Co. (ABC)

Upgrade to Buy from Hold

SAMPLE

► Last quarter operating EPS were \$0.12 versus \$0.07 a year ago and \$0.10 versus \$0.05 a year ago. Cost reductions have more than offset weaker sales and revenue.

► Cautious statements suggest that a demand surge is one to two quarters away. However, declining customer inventories could fuel above-average order growth when activity levels materially improve.

► We maintain our 2003 EPS estimate of \$0.30 but raised our 2004 projection to \$0.70 from \$0.65 due to a lower tax rate assumption. Due to ABC's position as a beneficiary of demographic changes in North America, boosted by cost reductions and the DEF acquisition, we raised our price target to \$18 from \$13 and our rating to Buy/Medium Risk (1M) from Hold/Medium Risk.

Share Price (mm/dd/yy):	Expected Share Price Return	23.2%
Expected Share Price:	Expected Dividend Yield	2.3%
Expected Dividend:	Expected Total Return	25.5%
Expected Total Return:		

FY December	2002	2001	2000	1999	1998
Revenues (mil.)	\$840	\$843	\$1,009	\$1,009	\$1,009
Current EPS	\$0.16	\$0.30	\$0.70	\$0.70	\$0.70
Previous EPS	—	—	—	—	—
P/E	81.2x	43.3x	18.6x	18.6x	18.6x

United States

Rating emphasizes the words "Buy/Hold/Sell" for clarity, rather than codes.

New statistical summary section clearly states components of Expected Total Return calculation for greater transparency.

New language for common stocks and options.

Sample Account Statement Page

SMITH BARNEY
citigroup

Preferred Client Statement
FMA PLUS

September 1 – September 30, 2003

JOHN SAMPLE

Account number 123-45678-18 387

Common stocks & options

Smith Barney Citigroup's research ratings may be shown for certain securities. Smith Barney's stock recommendations include an investment rating and a risk rating. The investment rating code (1, 2 or 3) is a function of Smith Barney's expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and Risk Rating. The Risk Rating (L, M, H or S) represents the stock's expected risk. It takes into account both price volatility and fundamental criteria. Please refer to the end of this statement for a guide describing the values used in research ratings. Your Financial Consultant will be pleased to provide you with further information or assist in interpreting research ratings.

2L
(Hold, Low risk)

Quantity	Description	Date Acquired	Cost	Share Cost	Current Price	Current Value	Unrealized Gain/(Loss)	Average % Yield Anticipated Income (annualized)
200	CCC CORP SYMBOL: CCC Research Rating: 1/M	06/17/98	\$ 8,882.15	\$ 44.26	\$ 48.39	\$ 9,578.00	\$ 815.86 LT	2.73%
200	HOV CORP SYMBOL: HOV Research Rating: 1/M	06/17/98	\$ 260.00	\$ 31.30	\$ 42.40	\$ 8,480.00	\$ 2,220.00 LT	1.51%
600	IMC INC SYMBOL: IMC Research Rating: 2L	01/13/94	\$ 9,907.80	\$ 14.84	\$ 57.72	\$ 34,832.00	\$ 27,724.20 LT	2.88%
400	MC CORP SYMBOL: MC Research Rating: 2L	08/10/99	\$ 2,342.40	\$ 20.60	\$ 40.72	\$ 16,288.00	\$ 8,045.60 LT	2.26%
200	MNN CORP SYMBOL: MNN Research Rating: 1/M	07/10/97	\$ 9,063.62	\$ 45.31	\$ 76.00	\$ 15,200.00	\$ 6,136.38 LT	1.74%
400	PJD CORP SYMBOL: PJD Research Rating: 2/H	10/30/90	\$ 1,892.00	\$ 4.23	\$ 8.09	\$ 3,236.00	\$ 1,544.00 LT	1.89%
100	RST CORP SYMBOL: RST Research Rating: 1/S	05/02/00	\$ 2,621.64	\$ 26.21	\$ 7.96	\$ 796.90	\$ (1,825.74) LT	1.72%
150	STS CORP SYMBOL: STS Research Rating: 2/M	11/15/94	\$ 404.00	\$ 2.69	\$ 8.98	\$ 1,347.00	\$ 943.00 LT	8.91%
150		07/18/99	\$ 2,494.21	\$ 16.62	\$ 8.98	\$ 1,347.00	\$ (1,147.21) LT	
150		07/24/99	\$ 2,056.02	\$ 13.70	\$ 8.98	\$ 1,347.00	\$ (708.02) LT	
450			\$ 4,864.23	\$ 11.01		\$ 4,041.00	\$ (823.23) LT	4.14%
Total common stocks and options			\$ 50,993.84			\$ 92,350.90	\$ 41,357.06 LT	2.13%

How Closed-End Funds Are Rated

Since our analysts do not assign a price target to closed-end funds, they are not rated on an absolute basis in the way other equity securities are. Instead, our analysts determine an investment rating for a closed-end fund by comparing its expected performance relative to its peer group. Risk ratings are determined by the quality, liquidity and exposure of the fund's investments.

Investment ratings for closed-end funds

1 = Outperform.

The fund's total return is expected to outperform its peer group, and/or the fund is expected to provide stable to rising dividends, where applicable.

2 = In-Line.

The fund's total return is expected to perform in line with its peer group, and/or the fund is expected to provide stable dividends, where applicable.

3 = Underperform.

The fund's total return is expected to underperform its peer group, and/or the fund is expected to provide a declining dividend, where applicable.

Risk ratings for closed-end funds

L = Low Risk.

The fund invests in high-quality, liquid securities with little to no financial leverage or foreign currency exposure.

M = Medium Risk.

Overall, the fund invests in moderate- to high-quality, liquid securities with reasonable financial leverage and provides primarily United States dollar currency exposure.

H = High Risk.

The fund may invest in low-quality, less-liquid securities, have exposure to foreign currencies and above-average degrees of financial leverage.

S = Speculative.

The fund invests in low-grade, illiquid and/or highly volatile securities, has exposure to foreign currency and may also use high degrees of financial leverage.

Important Questions and Answers About the New Stock Rating System

What is the purpose of a risk rating?

The risk rating is used to convey the analyst's view of the risks—both quantitative and fundamental—inherent in the underlying company and stock, and therefore serves as a guide to a risk-adjusted required return to justify an investment in that stock. Various factors may be considered in deriving the risk rating, including the historical price volatility, and these will be specified in the Risk section of the research.

Why are there no longer industry ratings?

Analysts are continuing to focus on company-specific research and industry insight. However, in order to improve the clarity of the rating for our investing clients, the new system does not require explicit or official industry ratings. Our macro research team members (Strategy/Economics/Technical/Quantitative), in consultation with our analysts, are providing guidance on sector and industry portfolio advice.

continued on page 5

Is this rating system used globally?

All regions use the same methodology for deriving an investment rating, but we have differentiated the risk-return assumptions between developed markets and emerging markets due to general differences in country/region risks. This means, for example, that we require a high-risk stock in an emerging market (e.g., Latin America) to deliver a higher return than a high-risk stock in a developed market (e.g., the United States) since the overall regional risk is higher in Latin America.

Developed markets are defined by the Smith Barney system as being the U.S., Canada, UK, Europe, Japan, Australia and New Zealand. Emerging Markets are Latin America, Asia Pacific (Hong Kong, China, South Korea, Indonesia, Malaysia, Thailand, Taiwan, Singapore and India) and EMEA (Africa, Emerging Europe and Middle East).

Why has the time horizon on price targets changed?

We have moved from 12 to 18 months to just 12 months to focus better on actionable investment ideas and strike a more optimal balance between intermediate- and long-term forces.

How does the new system apply to published research that does not include a key event such as initiation or changes in ratings and targets?

Target prices reflect long-term valuation assessments. However, day-to-day market conditions and unexpected events will drive volatility, which may cause temporary misalignment between the analyst's expected total return for a stock and the official ratings hurdle. Any deviation from the rating system's specified risk-return structure at the time of publication requires the Valuation section of the note/report to include a specific acknowledgement of this misalignment.

Important Disclosures

Guide to Investment Ratings:

Smith Barney's stock recommendations include a risk rating and an investment rating.

Risk ratings, which take into account both price volatility and fundamental criteria, are: Low [L], Medium [M], High [H] and Speculative [S].

Investment ratings are a function of Smith Barney's expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating.

For securities in developed markets (U.S., UK, Europe, Japan and Australia/New Zealand), investment ratings are: Buy [1] (expected total return of 10% or more for Low-Risk stocks, 15% or more for Medium-Risk stocks, 20% or more for High-Risk stocks, and 35% or more for Speculative stocks); Hold [2] (0% – 10% for Low-Risk stocks, 0% – 15% for Medium-Risk stocks, 0% – 20% for High-Risk stocks, and 0% – 35% for Speculative stocks); and Sell [3] (negative total return).

For securities in emerging markets (Asia Pacific, Emerging Europe/Middle East/Africa and Latin America), investment ratings are: Buy [1] (expected total return of 15% or more for Low-Risk stocks, 20% or more for Medium-Risk stocks, 30% or more for High-Risk stocks and 40% or more for Speculative stocks); Hold [2] (5% – 15% for Low-Risk stocks, 10% – 20% for Medium-Risk stocks, 15% – 30% for High-Risk stocks, and 20% – 40% for Speculative stocks); and Sell (5% or less for Low-Risk stocks, 10% or less for Medium-Risk stocks, 15% or less for High-Risk stocks and 20% or less for Speculative stocks).

Investment ratings are required to fall into the ranges described above at the time of initiation of coverage, a change in risk rating, or a change in price target. At other times, the expected total returns may fall outside of these ranges because of price movement and/or volatility. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. Your decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.

Between September 9, 2002, and September 12, 2003, Smith Barney's stock ratings were based upon expected performance over the following 12 to 18 months relative to the analyst's industry coverage universe at such time. An Outperform (1) rating indicated that we expected the stock to outperform the analyst's industry coverage universe over the coming 12 to 18 months. An In-line (2) rating indicated that we expected the stock to perform approximately in line with the analyst's coverage universe. An Underperform (3) rating indicated that we expected the stock to underperform the analyst's coverage universe. In emerging markets, the same ratings classifications were used, but the stocks were rated based upon expected performance relative to the primary market index in the region or country. Our complementary Risk rating system—

Low (L), Medium (M), High (H) and Speculative (S)—took into account predictability of financial results and stock price volatility. Risk ratings for Asia Pacific were determined by a quantitative screen which classified stocks into the same four risk categories. In the major markets, our Industry rating system—Overweight, Marketweight and Underweight—took into account each analyst's evaluation of their industry coverage as compared to the primary market index in their region over the following 12 to 18 months.

Prior to September 9, 2002, the Firm's stock rating system was based upon the expected total return over the next 12 to 18 months. The total return required for a given rating depended on the degree of risk in a stock (the higher the risk, the higher the required return). A Buy (1) rating indicated an expected total return ranging from +15% or greater for a low-risk stock to +30% or greater for a speculative stock. An Outperform (2) rating indicated an expected total return ranging from +5% to +15% (low-risk) to +10% to +30% (speculative). A Neutral (3) rating indicated an expected total return ranging from -5% to +5% (low-risk) to -10% to +10% (speculative). An Underperform (4) rating indicated an expected total return ranging from -5% to -15% (low-risk) to -10% to -20% (speculative). A Sell (5) rating indicated an expected total return ranging from -15% or worse (low-risk) to -20% or worse (speculative). The Risk ratings were the same as in the current system.

Guide to Investment Ratings—Closed-End Funds:

Smith Barney's closed-end funds recommendations include a risk rating and an investment rating.

Risk ratings, which take into account the quality and liquidity of the underlying securities, financial leverage and foreign currency exposure, are: Low [L] (fund invests in high-quality, liquid securities with little to no financial leverage or foreign currency exposure); Medium [M] (overall, fund invests in moderate- to high-quality, liquid securities with reasonable financial leverage, and provides primarily United States dollar currency exposure); High [H] (fund may invest in low-quality, less-liquid securities, have exposure to foreign currencies, and use above-average degrees of financial leverage); and Speculative [S] (fund invests in low-grade, illiquid and/or highly volatile securities, have exposure to foreign currency and may also use high degrees of financial leverage).

Investment ratings are based upon Smith Barney's expectation of the fund's total return relative to its peer group of closed-end funds, and the ability to provide stable to rising dividends, where applicable. Investment ratings are: Outperform [1] (fund is expected to outperform its peer group, and/or the fund is expected to provide stable to rising dividends, where applicable); In-Line [2] (fund is expected to perform in line with its peer group, and/or the fund is expected to provide stable dividends, where applicable); and Underperform [3] (fund is expected to underperform its peer group, and/or the fund is expected to provide a declining dividend, where applicable).

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